APPENDIX A
STATE COST CLUSTER ANALYSIS

STATE	State CPL	CPL Difference	Cluster Split Differences						
			2.50	2.00	1.55	1.50	1.00	0.85	0.50
Dist. Of Col.	16.0313								
New Jersey	18.09308	2.061777043		*	*	*	*	*	*
California	18.36228	0.269202909							
Massachusetts	19.18045	0.818170743							*
New York	19.546	0.365544777							
Nevada	19.71822	0.172222482							
Florida	19.86697	0.148755428							
Maryland	19.90223	0.035252677							
Rhode Island	19.99115	0.088927016							
Pennsylvania	20.64201	0.650853312							*
Arizona	20.7334	0.091390437							
Hawaii	20.77071	0.037317385							
Illinois	20.7727	0.001985659							
Utah	21.19423	0.421532696							
Virginia	21.87975	0.685516771							*
Texas	21.90215	0.022404339							
Alaska	22.01712	0.114966706							
Connecticut	22.06188	0.044759922							
Georgia	22.14027	0.078388394							
Minnesota	22.25597	0.11569615							
Washington	22.31244	0.056473756							
Wisconsin	22.71888	0.406439276							
North Carolina	23.18681	0.467928123							
Colorado	23.35272	0.16591541							
Ohio	23.36297	0.010249713							
Oregon	23.41386	0.050887279							
Michigan	23.50088	0.087019363							
North Dakota	23.97012	0.469238239							
Indiana	24.18936	0.219238314							
Iowa	24.28756	0.098201185							
Kansas	24.71672	0.42916505							
Puerto Rico	24.88505	0.168325153							
Missouri	25.07276	0.187712385							
New Hampshire	25.09483	0.022071128							
New Mexico	25.7026	0.607770941							*
South Carolina	26.05983	0.357227222							
Tennessee	26.37502	0.315191549							
Oklahoma	26.38137	0.006345897							
Louisiana	26.41917	0.037807808							
Idaho	26.9214	0.502222235							*
South Dakota	27.77254	0.851149266						*	*
Arkansas	27.96557	0.193025237							
Nebraska	28.20475	0.239177138							
Kentucky	29.78325	1.578497802			*	*	*	*	*
Maine	30.41798	0.634734615							*
Alabama	31.64293	1.22494751					*	*	*
Vermont	32.37634	0.733413484							*
Montana	32.72822	0.351882006							
West Virginia	33.43617	0.7079476							*
Wyoming	33.71669	0.2805202							
Mississippi	37.78217	4.065475787	*	*	*	*	*	*	*
Nat. Average	21.92357								
135% of Avg.	29.59681								

Note: The asterisks (*) indicate which states have a Cost per Loop (CPL) difference that exceeds the cluster split difference.

APPENDIX B
PARTIES FILING INITIAL COMMENTS

Commenter	Abbreviation
AT&T *Corp.*	AT&T
Rcacon Telecommunications Advisors, LLC	Beacon
BellSouth Corporation	BellSouth
Competitive Universal Service Coalition	CUSC
General Communications, Inc.	GCI
Maine Public Service Commission Montana Public Service Commission and Vermont Public Service Commission	Rural State Commissions
Massachusetts Department of Telecommunications And Energy	MDTE
Missouri Office of the Public Counsel	MOPC
National Rural Telecom Association and Organization for the Promotion and and Advancement of Small Telecommunications Companies	NRTA and OPASTA
National Telecommunications Cooperative Association	NTCA
Ohio Consumers' Counsel, Maryland Office of People's Counsel, Maine Public Advocate Office, Texas Office **of** Public Utility Counsel And Pennsylvania Office of Consumer Advocate	OCC et al.
Qwest Communications International, Inc.	Qwest
Rural Iowa Independent Telephone Associaton	RIITA
SBC Communications, Inc.	SBC
Texas, Public Utility Commission	Texas PUC
United States Telecom Association	**USTA**
Verizon telephone companies	Verizon

APPENDIX C
PARTIES FILING REPLY COMMENTS

Commenter	Abbreviation
AT&T Corp.	AT&T
Florida Public Service Commission	FPSC
GVNW Consulting, lnc.	GVNW
Maine Public Service Commission Montana Public Service Commission and Vermont Public Service Commission	Rural State Commissions
National Telecommunications Cooperative Association	NTCA
Ohio Consumers' Counsel. Maryland Office of People's Counsel, Maine Public Advocate Office. Texas Office of Public Utility Counsel And Pennsylvania Office of Consumer Advocate	OCC et al.
Qwest Communications International, lnc.	Qwest
SBC Communications, Inc.	SBC
Sprint Corporation	Sprint
Verizon telephone companies	Verizon
Wyoming Public Service Commission	WPSC

SEPARATE STATEMENT OF COMMISSIONER KATHLEEN Q. ABERNATHY

Re: Federal State Joint Board on Universal Service, CC Docket No. 96-45 (rel. Oct. 16, 2002)

I applaud the Joint Board's recommended decision that responds to issues raised by the remand of the Commission's non-rural mechanism by the Tenth Circuit in *Qwest Corp. v. FCC.*[1] Today's recommended decision responds to the court in several important respects. First, the Commission provides a more rigorous analysis of the cost data in the record to establish the cost-based benchmark that triggers support for noli-rural carriers. Utilizing cluster and standard deviation analyses. the Joint Board concludes that a benchmark set at 135% of national average cost is the appropriate trigger for federal support. This conclusion is consistent with the results of a recent General Accounting Office study that concluded that current rural and urban rates were not appreciably different under our existing universal service support structure.[2] As a result, I do not believe that the case has been made for radically altering the benchmark. The underlying data and the ultimate apparent success of our existing structure counsel a more consistent approach.

Although some have been critical of this data, there is nothing in the record that recommends a different result. Moreover, basing the benchmark on an urban average cost would not alone alter the level of support, but it would create a false sense of urgency around requiring higher levels of support — a conclusion unsupported by the statistical data or the GAO study. Our goal is to provide federal support based on costs that permit states to set urban and rural rates that are reasonably comparable. Granting support to high-cost states so that their net costs more closely resemble the national average is designed to allow them to set rates close to the national average. In turn, this process should result in urban and rural rates that are reasonably comparable. In contrast, a national urban average (a number inherently lower than the national average) would use federal support to drive costs down to the lower-than-average urban level without any evidence that affordability concerns warrant such a step. Our paramount goal in this proceeding is to ensure reasonably comparable rates — not to provide federal support to reduce the overall rate structure. Indeed, establishing a massive subsidy to drive rates down not only is unsupported by existing data on affordability but also would threaten to undermine our ability to provide support to other universal service programs that also have significant needs.

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[1] 258 F 3d 1191 (10th Cir. 2001)

[2] United States General Accounting Office, Telecommunications: Federal and State Universal Service Programs and Challenges to Funding (GAO-02-187, Feb. 4, 2002) (*GAO* Report). I also agree with the Recommended Decision that. because of the substantial differences in rate structures among states, it would not be feasible to base the suppon mechanism on rates alone (as opposed to costs) even if the rate survey identitied greater disparities. Moreover, if states could obtain additional universal service suppon for carriers merely by manipulating their rate structures. I believe that would invite abuse and ultimately frustrate the objectives set forth in the statute.

Second, the Joint Board has responded to the court's charge to create a state inducement mechanism to ensure that the rates actually paid by consumers are reasonably comparable. By requiring states to provide a certification and data about the comparability of urban and rural rates. the Commission ensures that ultimate rates as engineered by the state regulators reflect the same equity as the cost analysis and support provided at the federal level. In the event that state action and federal cost-based support prove insufficient, we have also created a mechanism for states to make individualized showings that modification of the cost benchmark or additional tailored support is warranted.

All members of the Joint Board worked extremely hard to develop this process to ensure the continued success of the universal service support mcchanism for non-rural carricrs. We are all deeply committed to this goal. 1look forward to working with my colleagues at the FCC and the Commission's staff to review these recommendations and promptly implement a non-rural support mechanism consistent with the Tenth Circuit's directives.

STATEMENT OF COMMISSIONER MICHAEL COPPS

Re: Federal State Joint Board on Universal Service, CC Docker No. 96-45 (rel. Oct. 16, 2002)

A core principle of the Telecommunications Act of 1996 is that all Americans should have access to reasonably comparable services at reasonably comparable rates. Congress was particularly concerned about consumers in rural, insular, and high-cost areas, whether served by rural or non-rural carriers.

In this Recommended Decision on a mechanism for high-cost support for non-rural carriers. the Joint Board recommends the use of statewide average costs in an initial effort to direct support to high-cost states. I support this methodology, but only insofar as there is an effective comparison of rural and urban rates at the end of the process to ensure that the statutory directive is met.

The Joint Board recommends that the Commission establish a safe harbor for comparing urban and rural rates, and provide any additional funding to reach this benchmark. The Joint Board indicates that 135 percent may be the appropriate benchmark. 1 do not find adequate evidence in the record to demonstrate that a rural rate for telephone service that is 135 percent higher than the average urban rate in this country is necessarily or reasonably comparable. Nevertheless, I support this Recommended Decision because the Joint Board expressly requests that the Commission further develop the record to establish the appropriate benchmark. I look forward to a full record on this issue from a wide variety of stakeholders when the Commission takes up this proceeding.

Finally, I emphasize that this Recommended Decision applies only to non-rural carriers serving rural America. The Joint Board has recognized that the assumptions in this decision such as using statewide average costs may well not be appropriate for rural carriers. I urge the Commission and the Joint Board to move forward expeditiously to address outstanding issues related to the high-cost mechanism for rural carriers to ensure that sufficient support is provided as required by the statute.

Congress has been clear – our duty is to ensure that comparable technologies are available all across this nation at affordable and roughly equivalent rates. Each and every citizen of this great country should have access to the wonders of communications. The statute and the public interest require no less.

SEPARATE STATEMENT **OF BILLY** JACK **GREGG,**
DIRECTOR **OF** THE CONSUMER ADVOCATE **DIVISION,**
PUBLIC SERVICE COMMISSION **OF** WEST VIRGINIA

***Re: Federal State Joint Board** on **Universal Service,** CC **Docket** No. 96-45 (rel. Oct. 16,* 2002)

Rates matter. Congress said so in the Telecommunications Act of 1996. Now. nearly seven years after the passage of the Act, the Joint Board has taken action to ensure that the real rates that real customers pay will be the ultimate test of the success of state and federal universal service policies. Telecommunications customers throughout the nation will be the beneficiaries ofthis decision.

In Section 254(b)(3) of the Act, Congress established the federal universal service principle that "...consumers in all regions of the Nation, including low-income consumers and thosc in rural. insular and high-cost areas. should have access to telecommunications ... at ratcs that are reasonably comparable **to** rates charged for similar services in urban arcas." [Emphasis added.] Although the wording of the Act is clear, up until now the Joint Board and FCC have designed universal service support mechanisms which steadfastly avoided consideration of the rates consumers actually pay.

The 10th Circuit Court of Appeals rejected the FCC's argument that it had "...no duty to ensure the reasonable comparability of rural and urban rates... ."[1] The Court held that the FCC was "...obligated to formulate its policies so as to achieve the goal of reasonable comparability..." and "...then to assess whether its funding mechanism will be sufficient for the principle of making rural and urban rates reasonably comparable."[2]

In response to the Court's remand, the Joint Board has finally added the critical missing piece to the existing funding mechanism. The procedures recommended by the majority in this decision will incorporate a rate review by the states as a part of the certification required under Section 254(e) ofthe Act. Such review should induce the states to take actions to use existing state and federal resources to achieve rates which are comparable to a national urban standard. If existing resources are inadequate, the states may request additional federal actions to enable comparable rates, including supplementary rate support. By definition, any additional federal funding will be targeted and sufficient to achieve the statutory goal of comparable rates. This common sense approach will properly respect the complementary roles of the federal and state authority in achieving rate comparability, and fairly balance the interests of high-cost and low-cost states in funding demonstrated universal service needs.

[1] Qwest Corp. v. FCC, 258 F.3d 1191 (10th Cir. 2001) at 1200

[2] Qwest Corp. v FCC, 258 F.3d 1191 (10th Cir. 2001) at 1201-1202

The universal service principle of rate comparability contained in the Act means that regardless of the evolution and vicissitudes of the competitive telecommunications market, the rates that consumers pay for basic services in the most rural and remote areas of our Nation will stay within shouting distance of the rates paid by their urban cousins. As the dynamic forces unleashed by the introduction of competition into all areas of telecommunications continue to surprise us, universal service provides a safety net that ensures that all Americans will benefit from this revolution, even if competitive choices are not immediately available in any particular arca. The procedures we recommend in this decision will go a long way toward making the universal service promise contained in the Act a reality, now and in the future.

STATEMENT OF
COMMISSIONER KEVIN J. MARTIN
Approving in Part, Dissenting in Part

Re Federal Bate Joinr Board on Universal Service, CC Docker No. 95-45
(rel Oct. 16, 2002)

I wish to thank all my colleagues on the Federal-Statc Joint Board for their hard work and contributions in tlic effort to reach consensus on the important issue of establishing a universal set-vice support system for non-rural carriers. I believe that today's effort, however. falls short in meeting our obligation to ensure that consumers living in rural and high *cost* areas have access to similar telecommunications services at rates that are reasonably comparable to rates paid by urban consumers.

Congress gave the Commission a clear mandate: to ensure that consumers in all regions of the nation have access to services that "...are reasonably comparable to those services provided in urban areas and that are available *at rates that are reasonably comparable to rates charged for similar services in urban areas* (emphasis added)."[1] Congress' direction is also clear regarding the obligation to establish mechanisms that are "...specific, predictable and sufficient ...to preserve and advance universal service."[2] In remanding the Commission's previous attempt to establish a federal-high cost universal service support mechanism for non-rural carriers, the United States Court of Appeals for the Tenth Circuit agreed that these fundamental guiding principles govern Commission action on any policies regarding universal service support mechanisms.[3]

Despite this remand, the majority's recommendation essentially reaffirms the Commission's existing universal service support mechanism for non-rural carriers. The decision continues to base support on forward looking costs and creates a sparsely defined second supplemental support system based on rate comparisons. Today's recommendation falls short in its response to the court mandate that we define the statutory term "reasonably comparable" for purposes of the cost-based support mechanism and fails to demonstrate, with any degree of specificity, how the proposed secondary mechanism will satisfy the statutory requirement that universal service support be "specific, predictable and sufficient."

For these and the reasons explained below, 1 respectfully dissent from portions of the majority

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[1] See 47 U.S.C. 254(b)(3).

[2] See 47 U.S.C. 254(b)(5).

[3] *Federal-State Join Board on Universal Service,* CC Docket No. 96-45, Ninth Report and Order **and** Eighteenth Order *on* Reconsideration, 14 FCC Rcd 20432(1999)(*Ninth Report and Order*) ***remanded***, *Qwest Corp. v. FCC,* 258 F.3d 1191, 1199 (10th Cir. 2001).

opinion today.[4]

Use of Costs as a Surrogate for Rates to Determine Non-Rural High Cost Support

Section 254(b)(3) of the Communications Act requires that universal service support mechanism ensure that telecommunications services in all regions of the nation be provided at reasonably comparable "rates." The majority, however, recommends continuing the practice of using costs rather then rates to determine federal support. I am not convinced that a mechanism based solely on costs would meet the statutory mandate requiring a comparison of rates.

Moreover. I fear that the recommended decision may be either arbitrary or not fully thought through. If the Joint Board is confident that a cost-based support system satisfies our statutory obligation to produce reasonably comparable rates, then why does it propose establishing an entirely new support mechanism based on rate comparisons? Similarly, if the Commission were to adopt the Joint Board's recommended "supplemental rate comparability review," why should it not abandon the cost-based support mechanism and instead rely solely on the rate-based support mechanism? If we need the supplemental rate comparison to meet our statutory obligation, would it not be simpler to have only one mechanism rather than two? These questions seem to remain unanswered by the majority.

The majority's rejection of rate-based distribution and support for a cost-based mechanism is based on two arguments: (i) an analysis of disparate local rate design practices throughout the nation remains too difficult a task; and (ii) the use of costs reflects the federal government's primary obligation to support only those states that "do not have the resources within their borders to support all of their high cost lines."[5] In my view, both of these arguments fail to support the Joint Board's position.

First, in response to the argument that such an analysis is too difficult, the majority appears to create just such an analysis in its "supplemental rate comparability review." The majority **also** fails to note or even address the fact that many of the issues and data necessary to perform a rate-based comparison will be needed in the context of initiating the proposed catch all "supplemental rate comparability review." On its face, one well-defined support mechanism based on rate comparisons would appear to present an equal or lesser administrative burden for the Commission, the states and carriers compared to the dual cost-based and rate-based mechanisms recommended by the majority today.

The majority's recommendation also contains an inherent presumption that the federal government's role in establishing a suppon mechanism is apparently limited to equalizing cost

[4] In addition to the reasons discussed **below,** I also agree with and join in many of the concerns raised in Commissioner Bob Rowe's thorough and thoughtful analysis in his dissent.

[5] Recommended **Decision** at **paras.** 19-21, 24.

discrepancies between states but not equalizing rate discrepancies between rural and urban areas.[6] I disagree. The statute is clear. Our job is to ensure that services in rural and high cost areas are "available at rates that are reasonably comparable to rates charged for similar services in urban areas."[7] The 10th Circuit explicitly rejected the FCC's contention that it had no duty to ensure the reasonable comparability of rural and urban rates and stated that we are "obligated *to* formulate policies so as *to* achieve the goal of reasonable comparability..."[8]

In my view, if the Commission is only going to address discrepancies between and among states, then there must be a requirement that states address such discrepancies within their borders. Whether such a requirement compels rate averaging within states or requires that a state universal service mechanism be in place, such action must address differences in cost between rural and urban areas. Yet this decision fails to require that such inequities between urban and rural rates he addressed."

The proposed expanded rate certification mechanism is insufficient. Under the proposed certification process, states would be permitted to report rates that are not "reasonably comparable" according to the benchmark. Such rates could eventually be allowed to meet the "rcasonably comparable" standard if a state demonstrates "additional services included in the basic service rate" or by outlining "the method in which the slate has targeted existing universal service support."[9] In my view, such a certification process is insufficient without a standard enunciating the allowable discrepancy for intrastate rates.

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[h] Recommended Decision at paras. 25-26. "The Commission's primary role is to identify those states that do not have the resources within their borders to support all of their high-cost lines.... The Commission explained in the *Ninth* ***Reporr and Order*** that the non-rural high cost support mechanism "has the effect of shifting money from relatively low-cost states to relatively high-cost states. The Commission believed that its non-rural suppon mechanism ensured that no state with costs greater than the national benchmark would be forced to keep rates reasonably comparable without the benefit of federal support ...We continue to support these policies."

[7] 47 U.S.C.254(3).

[8] 258 F.3d at 1200.

[9] See *Ninth Report and* ***Order*** at 20482-3, para. ***95*** (The Commission found it most appropriate to allow states to determine how non-rural cost support is used, "[b]ecause the support, .is intended to enable the reasonable comparability of intrastate rates, and states have primary jurisdiction over intrastate rates."; *see* id. At 20483, para. *96* **("As** long as the uses prescribed by the state are consistent with 254(e), we believe that stares should have the flexibility to decide how carriers use support provided by the federal mechanism."). See Recommended Decision at *paras.* 43-56. Even in light ***of*** the 10th Circuit remand requiring the Commission lo consider appropriate state inducements to address reasonably comparable rates, the Joint Board fails to consider recommending either a state averaging mandate or mandatory state universal service mechanism requirement to address discrepancies between costs in rural and urban areas.

[10] Recommended Decision at para. 55

Sufficiency of High-Cost Support under the National Average Cost Benchmark

Even if costs can be used as a surrogate, I question the majority's recommendation to use the 135% benchmark to ensure that rural rates are "reasonably comparable."

In deciding to proceed with a cost-based methodology to ensure reasonably comparable "rural" and "urban" rates, we should compare "rural" costs to average "urban" costs. The Commission certainly has data readily available to perform this comparison. Under the Synthesis Cost model, cost data can be produced by density zone or at the wire center level. Yet, the majority summarily rejects the concept of an "urban benchmark," setting a benchmark at 135 percent of national average cost. In the process, the decision sidesteps the question of whether the benchmark produces sufficient support in light of the existing disparity between national average cost and the lower average urban cost.

As Commissioner Kowe notes, the majority's rejection of the urban benchmark is "confusing and unpersuasive."[11] The majority never tackles the uncomfortable fact that the 135 percent benchmark is *too* high because national average costs arc already higher than urban costs because they include in the national average the very rural areas at issue. In other words, the high costs associated with serving rural areas are used twice: once to raise the national average and again in comparison.

Let me illustrate my concern with a simple example. If half of the country lived in an urban area with costs of $1 0 and the other half of the country lived in a rural area with costs of $30, the difference between the costs of the average urban area and average rural area would be $20. But if a national average were taken, including the costs of the rural areas, the national average cost would be $20. If support were then based on the difference between the rural cost ($30) and 135% of the national average (1.35 x $20=$27), each rural resident would have costs of $27 ($30-$3 of support) and each urban resident would have costs of $13 ($10 + $3 of support). I do not believe that such a methodology sufficiently addresses the reasonable comparability of rural and urban costs. The inclusion of rural costs in the average along with the adoption of a 135% benchmark systematically underestimates the costs of rural areas."

Instead, the majority finds fault with the use of an urban benchmark based on the fact that it "substitutes costs for rates" and "compares statewide average costs to nationwide urban costs."[12] The majority's criticism appears strangely out of place given that its own recommendation is also based on a cost-based support system. I find it ironic that the majority can justify its "existing system on the ground that costs equal rates, and at the same time rejects all changes on

[11] *See* Commissioner Bob **Rowe's** Separate Statement at **8.**

[12] National averages could be used without a benchmark or urban averages could be used with a benchmark but the combination of the two mechanisms is arbitrary

[13] Recommended Decision at para. 39

the ground that costs do not equal rates."[14]

It also rejects the urban benchmark because it would "require more funding or a higher benchmark level because urban average costs are lower than national average costs."[15] I fail to see how the potential for greater funding levels should prevent us from adopting a support system that meets our statutory obligation.[16] Indeed, I fear that this reasoning reflects an analysis that concluded first that there would be no additional funding for rural areas and second adopted a mechanism to assess "reasonable comparability" that achieved that result. I believe our statutory obligation was to achieve reasonably comparable urban and rural rates even if that "requires more funding" than the current system provides.

Nor do I understand how the majority reaches the conclusion that the urban cost benchmark fails to "better satisfy the statutory comparison of urban and rural rates."[17] I join Commissioner Rowe in questioning how the majority finds that additional "incremental support would be ineffective at producing comparable rates, but existing support passes the test."[18]

In addition, I question the use of forward-looking costs as the basis for distributing universal service support. Today, rates are set in most states through the use of actual costs not hypothetical replacement costs. Forward-looking costs have little, if any, nexus to the establishment of end user retail rates. Use of these costs for calculating universal service support results in support being provided to some areas with low end user rates while certain areas that have high rates receive insufficient support. In my view, we could better achieve comparability of rates if we based our universal service support system on actual rather than forward looking costs.

Finally, the majority cites three studies/analyses in support of its decision to continue using the 135 percent benchmark. I disagree with the majority's conclusion that these studies support its decision to retain the benchmark. First, the majority points to the General Accounting Office (GAO) study to show that national averages of rural, suburban and urban rates are affordable and reasonably comparable. The majority, however, fails to acknowledge serious deficiencies in the GAO study that fail to support the use of the benchmark for non-rural carriers.'* For example, the GAO study includes data from areas served by rural carriers, areas that are not relevant to the establishment of non-rural carrier support system. In addition, GAO's rate comparison ignores

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[14] *See* Commissioner Bob Rowe's Separate Statement at 8

[15] ***Id.*** at 40.

[16] The United States Department of Agriculture's Rural Utilities Service (RUS) recommended adoption of a benchmark tied to the national average urban loop cost or another statistical indicator more representative of urban costs, not the national average costs. RUS notes that 135% of the national average (urban and rural) "loop cost" exceed its estimate of urban "loop costs" by ***233%.***

[17] Recommended Decision at 39. (emphasis in original).

[18] ***See*** *also* Commissioner Rowe's Separate Statement at 2-3.

whether rates in different service areas apply to comparable services. Moreover, national averages cited by GAO do not assist the Commission in addressing our core responsibility of whether rates in certain rural or high cost areas are comparable to rates in urban areas, or even whether rates vary significantly from state-to-state. To the contrary, as Commissioner Rowe points out, **GAO's** data demonstrates a vast disparity on state rates (e.g., residential rates at two Wyoming locations exceeding $40 versus residential rates in Roaring Springs, Texas of $7.10).[19]

I also join Commissioner Rowe's dissent asserting that a standard deviation analysis fails to justify the current benchmark." I find it particularly troubling that the majority arbitrarily raises the benchmark to 135 percent even in light of its own analysis demonstrating that 2.0 standard deviation above the national mean results in a 132 percent benchmark. The majority offers no reasoned basis why states should be denied the additional $.50 per customer per month of support that would result hy applying the results of the majority's own standard deviation analysis.

Supplementary Rate Review

The majority: **in** today's recommendation, sets forth an additional supplemental process for rate comparison. It recommends adopting a new and vaguely defined supplemental mechanism. Rather than provide a clearly defined mechanism the majority instead offers an ad hoc process where the specific mechanisms will apparently develop on a case-by-case basis.[21] The majority envisions a process where States seeking additional federal support will be required to provide a "rate analysis," and will have "great flexibility" in demonstrating that rates are not reasonably comparable."

In my view, the majority's "supplementary rate review" is striking similar to the state-by-state cost study approach the Commission had originally rejected in order to pursue its flawed nation-wide universal service cost model approach. Under the recommended state-by-state approach, each state would have significant latitude to suggest its own procedures for adjusting rates. Without specific guidelines or a clearly defined standard, this approach appears to invite the potential for uneven and potentially discriminatory results.

I am troubled that majority fails to offer any specific guidance on critical areas of its newly proposed process. The item is silent, for example, on whether states should alter rates to take into account the scope of certain local calling areas or differing calling plans. In my view, without an established standard or guidance for states in this area, the poorly defined "supplementary rate review" will most likely provide results, if any, that are highly susceptible to

[19] *Id* at 3.

[20] *Id* **at** 5-7.

[21] *Id at* 16.

[22] Recommended Decision at **para.** 56

legal challenge.

Finally, Commissioner Rowe is correct in questioning whether the proposed "supplementary rate review" would "create perverse incentives for carriers."[23] One of the reasons the Commission adopted the forward-looking cost model was because it believed that an embedded-cost support system promotes inefficient investment that would inhibit competitive entry. I find it ironic that the majority now **seeks** to adopt a rate-based mechanism that inherently relies on local rates which arc typically based on embedded costs.

[23] *See* Commissioner Bob Rowe's Separate Statement at I8

SEPARATE STATEMENT OF COMMISSIONER THOMAS J. DUNLEAW
NEW YORK STATE PUBLIC SERVICE COMMISSION
Approving In Part and Dissenting In Part

Re. Federal State Joint Board on Universal Service, CC Docker ***No. 96-45***
(rel Oct. 16, 2002)

I support this Recommended Decision (RD) to the extent that it confirms and endorses continued use ofthe Commission's existing high-cost support mechanism for noli-rural carriers. I agree with the Joint Board's suggestion that existing rates are affordable and reasonably comparable. I have seen no evidence that services and rates in "all regions of the Nation" are not reasonably comparable. In my view. this confirms that the existing mechanism, in concert with the other available federal universal service support mechanisms, provides sufficient support to achieve the purpose for which it is intended. I believc that the standard deviation and cluster analyses cited in the RD provide sufficient justification for the retention of both the existing cost-bascd mechanism and its cost benchmark of'135% of the national average forward-looking cost. Further. I agree that requiring states to certify whether thcir rates are reasonably comparable responds adequately, as I read it, to the Tenth Circuit's requirement that the Commission somehow induce states to fulfill thcir own obligations to ensure reasonably comparable rates.

I must respectfully dissent, however, from those portions of the RD that suggest that states should be invited to seek additional "targeted" support based on a comparison of rates and that a rate benchmark of 135% of the average urban rate may be appropriate for making that comparison. It does not appear to me that this suggestion is supported by the evidence. Because the RD itself concludes that the record for choosing a rate benchmark must be further developed, it should not suggest that any particular value might be appropriate.

Having endorsed continued use of the current cost-based mechanism for calculating non-rural support, the Joint Board then incongruously suggests that states should be invited to seek supplemental support based on an analysis of their rates. In so doing, it proposes creation oftwo fundamentally different support mechanisms, between which each recipient state would be invited to choose to use the more lucrative for itself. The suggestion that such a supplemental support mechanism should be created implies that the majority questions the sufficiency of its primary cost-based mechanism. 1do not.

As explained in the RD, it is extremely difficult, if not impossible, to make meaningful rate comparisons among states. The RD hints at some of the difficulties in paragraph 19, but ignores what, in my view, is perhaps the largest problem - normalizing rates for the varying local calling capabilities they may encompass. For this reason, the Joint Board has now twice concluded that cost analysis, as a proxy for rate analysis, is the preferred approach and the Commission has so agreed. Nevertheless, the RD implies that the Commission will indeed be able to create the necessary rules and algorithms to perform such normalizations, make such rate comparisons and, most importantly, determine appropriate amounts of supplemental support. With the greatest

respect and admiration for the skills of the Commission, I do not share the majority's optimism on this score.

Additionally: I am also concerned that the RD may contemplate comparison of each wire center's rate to a national benchmark rate in order to calculate the proposed supplemental rate-based support. If *so,* it seems to me that it would reverse its own finding that high-cost support should be calculated based on statewide, not wire center. costs. That would fundamentally alter the Commission's role in high cost support, which as both the Joint Board and the Commission have round. is to effect necessary statc-to-state transfers of monies, not transfers within states.

It appears to me that, in the final analysis. the uncertainty that surrounds this ill-defined support proposal is its most troubling attribute. Until the extremely difficult decisions have been made about how to normalize rates and what criteria to apply in determining supplemental support, it is impossible to even estimate how much support it might produce or where that support might go. Potential recipients cannot even guess how much support they ultimately will receive: payers can only speculate on how much cost they will be asked to bear. Consequently, the Commission will be hard pressed, in my view, to explain to the court how its mechanism will, in fact, produce reasonably comparable rates.

SEPARATE STATEMENT OFCOMMISSIONER BOB ROWE,
MONTANA PUBLIC SERVICE COMMISSION
Dissenting

Re: Federal State Joint Board on Universal Service, CC Docker No. 96-45 (rel. Oct. 16, 2002)

I respectfully but strongly dissent from this Recommended Decision. The 10th Circuit Court of Appeals required the FCC to demonstrate that the statutory requirements of section 254 of the Act were met. In order to do this, the FCC was required to define and recognize in its decision certain key statutory terms. such as "reasonably comparable" which animate section 254. The court also directed the Commission either to explain how the 135 percent benchmark used in the current formula complies with the established definition of "reasonably comparable" or to establish a new benchmark that does meet the statutory requirements, including the requirement of providing sufficient support to allow states to achieve reasonably comparable rates. The Recommended Decision fails these tasks.

'The Recommended Decision does not demonstrate that the Joint Board has impartially examined and addressed these questions. The recommended decision does not even demonstrate that the Joint Board has considered these issues in a manner that I believe was contemplated by the Court. Rather, the Recommended Decision embraces a variety of flawed arguments that purport to justify continuation of the status quo. I am unpersuaded by these arguments and conclude that if the Recommended Decision were adopted by the Commission some "nonrural" carriers (more properly large companies serving high cost areas) would not receive sufficient support, and rural rates *and services* in some states could not be reasonably comparable to those in urban areas.

The majority concludes that the statute can be satisfied by two quite different support systems: continuation of the existing system based on forward-looking costs; and a second, supplemental, support system based on rates. For different reasons, I conclude that each is seriously flawed. Even taken together, they fail to provide sufficient support to meet the legal requirements of the Act.

A. Cost-Based Support

The majority recommends continuing primary reliance on the existing cost-based support system, and continuation of the current 135 percent benchmark. That benchmark is a critically important variable in the support system. The benchmark is now set by rule at 135 percent of the national average cost produced by the Commission's forward-looking cost model.' In 2002, that works out to $29.60 **per** line per month.[2]

'47 C.F.R. § 54.309(a)(3)

[2] This is 135 percent **of** the current national average **cost** among nonrural carriers of $21.9235.

This "dollar benchmark" has a simple meaning for nonrural carriers: in any state where the average unseparated forward-looking cost of providing service is more than $29.60, federal support will reduce the net cost in that state to $29.60. This is accomplished by a combination of cost separation policy [3] and universal service support.[4]

A dollar benchmark that is too high produces two forms of harm. In the very highest cost states, too little support is provided. The net costs of high-cost carriers in those stales necessarily remains too high, above a level reasonably comparable to the net costs of carriers serving urban areas. Second, states with somewhat lower cost receive no support whatever, even though their costs are above the level that is reasonably comparable to costs in urban areas.

The majority offers three justifications for keeping the 135 percent benchmark: a study by the United States General Accounting Office (GAO). "cluster analysis," and "standard deviation analysis." In my view, each of these justifications has fundamental flaws. and none of them support the majority's conclusion that the 135 percent benchmark should be retained. Morsovcr, the Recommended Decision incorrectly rejects arguments for an "urban benchmark" and overlooks substantial evidence that the existing benchmark produces insufficient support to nonrural carriers. Finally, the majority never defines "reasonably comparable" in reference to cost-based support as is required by the Act and the 10th Circuit's decision.

1. The GAO Study

The Recommended Decision cites a study of telephone rates conducted by the GAO. The GAO gathered data from state commissions on local telephone rates in sampled locations throughout all fifty states and the District of Columbia.' Within each state, GAO randomly selected locations from three broad categories associated with population density: central city, suburban (other places within a metropolitan statistical area. MSA), and rural (outside MSA). Based on data contained in the GAO study, the majority finds that "the national average of rural, suburban and urban rates for residential

[3] Some of the operating and capital costs of each incumbent local telephone company are "separated" to the interstate jurisdiction. Revenues to recover these costs come from a variety of sources controlled by the Commission.

[4] High cost support amounts to 16 percent of the difference between the state's average forward-looking cost and $29.48. The 16 percent figure was selected as the average separations factor nationwide. It was adopted to prevent double-recovery of costs that are otherwise recovered through interstate revenues.

[5] For residential and single-line business customers, GAO asked for the unlimited service rate and the message or measured service rate with the lowest rate. The rates do not include the Federal Subscriber Line Charge; state and local surcharges for items such as state universal service funding, 911 service, and taxes; the federal excise tax; or long distance fees and associated universal service charges and other taxes. Where offered, GAO used the tariff rate for unlimited service. Where unlimited service is not available, GAO calculated a monthly fee for a "representative customer" using the message rate. GAO assumed that a "representative customer" makes 100 5-minute calls per month.

customers diverge by less than two percent." While this may be a correct statement, based on their methodology, for three reasons it fails to support the 135 percent benchmark.

First, the GAO study collected data from all parts of the nation, including areas served by nonrural carriers and areas served by rural carriers. The GAO made no attempt to exclude data from areas served by rural carricrs, areas that are not under consideration here.[6] The support systems for rural and nonrural carriers are different in important ways, and data from rural carriers can mask important trends in the rates of nonrural carriers. A related deficiency is that the GAO made no effort to determine whether the rates that they measured in different areas applied to comparable services. Therefore the GAO failed to control for two significant variables. and its study conclusions cannot inform the selection of a benchmark for nonrural carriers.

A more fundamental problem is that national averages are at the wrong geographic scale to inform the benchmark issue. The national average is defined by low-rate areas as well as high-rate areas. This overlooks the relevant policy variable. which is slate-to-state rate variation. The question under section 254 is whether rates or costs in one or more rural, insular or high cost areas ai-e too high in relation to rates or costs for comparable services in urban areas. National averages are irrelevant to this question.[7] It is easy to imagine a situation in which there is a section 254 problem but national averages are exactly equal.

The **GAO's** own data demonstrate that this is not a hypothetical problem and that rates vary significantly from state to state. According to the report, residential rates in Roaring Springs, Texas were $7.10 per month. By contrast, all of Wyoming and all of Vermont reported residential rates above $23. At the extreme, residential rates at two locations in Wyoming reportedly exceeded $40. In short, the GAO data tend to show, if anything, that there are rate differences in the country that are significant enough to be of concern under section 254.

Finally, the GAO Report itself had several methodological problems. The sample size used in the study was too small to be statistically valid for any state. Second, the study overlooked some kinds of local exchange charges that must be paid by all end users. Third, the study reported raw rates, and made no correction for calling area size or other quality of service variables. Finally, in areas where more than one local calling area is offered, the GAO did not even pick consistent rates. For example, in Michigan the

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[6] The GAO did not develop consistent data from state to state. In some states rural data was included, but not in other states.

[7] The scale problem can be understood more generally with a simpler set of facts. Suppose that every state has geographically averaged rates. (This much is not far from the truth in many states.) Further suppose that in 40 states all customers pay $5 per month and in the other 10 states all customers pay $50 per month. In each state considered separately, the GAO study would show that rates for rural and urban areas are equal. Therefore when all stares are aggregated together, urban and rural averages will also be equal. This is rrue even though rates in some states are ten times the rates in most states.

study reported the local rate as $49 per month, but a footnote shows that the most common rate is $12 The GAO study was a commendable effort by an agency that has no expertise in the complexities of local exchange rates. I do not believe that the GAO data have been shown to be sufficiently accurate and normalized so that they can support relevant inferences here.

2. Cluster Analysis

The majority also found that the 135 percent benchmark is empirically supported by "cluster analysis." This is described as "an analytical technique that seeks to organize information about variables so that relatively homogeneous groups, or clusters can be identified." The underlying data are the statewide average costs produced by the Commission's forward-looking cost model. Cluster analysis places the states in rank order of cost and then examines the cost differences between successive states. Where a significant cost difference exists from one state to its next neighbor in the list, cluster analysis considers this a significant fact.

The highest cost state is Mississippi. This year: Mississippi and the next seven states on the ranked list rsceivs support. The last of these, Kentucky, has a cost of $29.78. The very next state on the list, which receives no support, is Nebraska. It has a cost of $28.20. The cost difference between Kentucky and Nebraska is therefore $1.58. **As** it happens, this is an unusually large gap; most other states are separated from their neighbors by smaller cost differences and thus are more like their neighbor in the list than are Nebraska and Kentucky.

The majority concludes that cluster analysis shows that the "135 percent benchmark targets support to states with substantially higher average costs than other states."[8] Of course, any benchmark would target support to the highest cost states. That is nothing more than a design feature of the support system. Therefore, the majority must be placing reliance on the *size* of the cost difference between Kentucky and Nebraska. The $1.58 gap between Kentucky and Nebraska is therefore the sole fact underlying the majority's argument.

Cluster analysis does not provide any useful information or guidance in selecting a specific benchmark. The method used to select the clusters is arbitrary, and the approach suffers from several deficiencies. Most basically, it says nothing about whether support is sufficient. While the analysis does show that states like Kentucky (and higher cost states) are **at** least somewhat different from states like Nebraska **(and** lower cost states), it says nothing about whether costs in the higher costs states (or in Nebraska for that matter) are reasonably comparable to urban areas.

Second, even assuming for the sake of argument that cluster analysis could have some probative value, the majority has justified a permanent feature of the support system on transient data. The 135 percent benchmark is a fixed parameter that is permanently

[8] Recommended Decision, ¶ 34.

codified in rule. Yet each year that fixed benchmark is applied to a new set of cost data, and the individual state costs change significantly over time.[9] Between the 2001 and 2002 support years, more than two-thirds of the states saw their average cost change by $0.50 or more[10] and one-third saw thcir average cost change by $1.00 or more." When data are that volatile from year to year, the results from any one specific year, such as 2002, cannot fairly support the selection of a permanent benchmark.

The effect of data volatility is illustrated by applying cluster analysis to data from other years. In 2001, for example: the cost gap between Nebraska and Kentucky was cvcn larger than in 2002.[12] Cluster analysis would presumably have concluded even more strongly that Nebraska's lower-cost group and Kentucky's higher-cost group should be treated differently. However, in 2001, as it happened, neither Kentucky nor Nebraska received support. If cluster analysis had been applied a year ago, then, it would have supported *reducing* the 135 percent benchmark so that Kentucky could get some support.

Third, the cluster analysis does not provide a unique solution at the 135 pcrcent benchmark. Cluster analysis purportedly shows that Kentucky (and higher cost states) should receive support and that Nebraska (and lower cost states) should not. However, that result can be achieved by selecting a benchmark as low as 129 percent and as high as 135.5 percent. The majority docs not explain how cluster analysis guided its selection of 135 percent from this range. This is an important distinction because the use of a 129 percent benchmark would have increased support to every state now receiving support by $1 .00 per line per month."

In summary, the majority uses cluster analysis to support retention of the existing 135 percent benchmark even though cluster analysis is irrelevant to sufficiency, even though the method attributes inappropriate significance to apparently transient cost differences, and even though the analysis equally supports the adoption of significantly different benchmarks.

3. Standard Deviation Analysis

The majority asserts that the 135 percent benchmark is supported by "standard deviation analysis" since "an analysis of the Commission's cost model shows that two standard deviations translates approximately to a 135 percent cost benchmark."[14] The

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[9] Between 2001 and 2002, costs in 18 states declined by more than $1.00 per line per month, and costs in three states declined by more than $2.00.

[10] This group comprised 36 of 52 jurisdictions

[11] This group comprised 18 of 52 jurisdictions

[12] The gap in that year was $2.12

[13] A benchmark of 129 percent is 6 percent lower than 135 percent. The support difference for each carrier already receiving suppon would be $21.93 x 6% x 76% = $1.00.

[14] Recommended Decision, ¶ 35.

majority explains that standard deviation analysis is a "commonly used statistical analysis" and that using two standard deviations will "identify data points which are truly outliers within the sample studied."" I have concluded that standard deviation analysis does not validate the I35 percent benchmark.

The most fundamental problem **is** that the majority would substitute for the existing statutory standard a new and different standard that is not even conceptually related to reasonable comparability." The standard deviation analysis apparently relies on the premise that only "outlier" states should receive support. But this measure of who is an "outlier" is defined by standard deviations. This in turn depends not only on the magnitude of the cost differences between a high-cost state and urban areas, but by the cost assigned to every state. The overall pattern of state costs, rather than the differences between the extremes dcfincs the outcome. Even where urban costs are low, the prcsencc of many semi-rural states would raise the national average and could also increase the standard deviation. Each of these forces would reduce support for high-cost states. Indeed, it is easy to imagine circumstances under which *no state* is more than two standard deviations above the mean, but many have costs that are not by any reasonablc measure comparable to urban costs. The majority has not shown that, or even discussed whether, the two standards are the same.

The absence of that showing has led to the second flaw with this approach. Standard deviation analysis actually does produce a benchmark that is too high to produce sufficient support. To understand why, it is instructive to consider how far "out" a state must lie in order to be an "outlier" under the majority's analysis. The majority reports that cases "within two standard deviations of the mean will comprise approximately 95 percent of all data points." This is accurate under some conditions, but not here. Here we should be interested in how many *high-cos/* cases exist, not in the total of *high-cos/ and low-cost* states." Under those circumstances, only 2.3 percent of the cases in a normal distribution fall outside the limit oftwo standard deviations." This is an important finding. If state costs were normally distributed, standard deviation analysis would suggest that support should be provided only to states in the 99^{th} and 98^{th} percentiles of cost, and to some of the states in the 97^{th} percentile." **As** a result, several states fall below two standard deviations and below the 135% benchmark, but they are left with net costs that are still far above urban costs. This is solely the result of the fact, based on the

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[15] Recommended Decision, ¶ 36

[16] I note that the court has already rejected earlier efforts to redefine the statutory standard

[17] This calls for use of what is normally referred to as a "one-tailed" test.

[18] In a "z" distribution, the probability ofa case falling between 0 and 2 standard deviations is 0.4772. This means that the probability ofa case falling above *2* standard deviations is $1 - 0.5 - 0.4772 = 0.0228$ or 2.28 percent.

[19] Since 2.0 standard deviations includes 2.3 percent of a normal distribution, only 30% of the states in the 97^{th} percentile would he included.

cost patterns of all of the states, that their costs are not high enough to make them "outliers."'"

1 know of no basis to conclude that this is a reasonable interpretation of section 254. Indeed, it is a substitution of a significantly more restrictive standard. Nothing **I am** aware of in the legislative history of the Act suggests that Congress intended universal service support *to* be available only to carriers or states in the top three percentiles of cost. I conclude that standard deviation analysis would improperly substitute a new and more restrictive standard for the standard contained **in** the statute. It is not merely an interpretation of that statutory standard.

'The majority suggests the use of the standard deviation places the 135 percent benchmark on a stronger scientific footing. I do not agree. Although the analysis cites a statistical variable, thcre is nothing in the science anti art of statistics that suppoi-1s this variable *as* a yardstick for cost benchmarks.

Standard deviation analysis is certainly useful in some scientific and public policy applications. Sometimes data will bc excluded if they fall outside a statistical limit such as two or three standard deviations. The assumption is that these "outlying" measurements were the product of a measurement error ofunknown origin. By excluding the suspect data, one can expect to increase the reliability of the inferences drawn from the surviving data. This procedure for excluding data is not only used in science, but, as the majority notes, it is also used in telecommunications regulation. For example, it is used to discount service quality failures that might unjustly lead to penalties unless they are disregarded. The fact that standard deviation analysis may be useful in some public policy situations does not establish that it is useful here. Here the majority apparently conflates "outlying" and unreliable data with "outlying" high-cost states. Despite the superficial similarities. I believe the two situations are fundamentally different, and the analogy is inappropriate. We are clearly not seeking here to identify any unreliable data in order to discard it. Indeed, the majority's analysis would not lead to exclusion of any data points. *On* the contrary, once the benchmark has been set, the Commission will then rely on precisely the same cost data for "outlying" states to calculate and distribute tens of millions of dollars of support.

In what way, then, does standard deviation analysis illuminate the task before us, which is better to define what Congress meant by "reasonably comparable?'' It appears that the majority believes that we should define when rates are reasonably comparable using the same standard by which statisticians eliminate unreliable data. I know of no statistical theory that suggests this equation.[21] The tasks are fundamentally different, and solutions used to solve one kind of problem are not appropriate to the other. As used,

[20] Moreover, because the benchmark is **too** high, even in those states that do receive some support, the amount is insufficient.

[21] Nor **is** the majority here using standard deviation analysis to test any statistical hypothesis. Scientists sometimes use standard deviations to test a hypothesis thai a sample of cases is statistically different from a larger population. No such hypothesis has been stated here. and there is no sample **to** be tested.

standard deviation analysis does not add any statistical or scientific validity to the majority's decision about the appropriate benchmark.

Standard deviation analysis suffers from several additional problems. The majority's analysis perpetuates one of the errors already identified by the court. It is based upon the cost characteristics of all states, not the cost characteristics of urban areas, or even of urban states (assuming such states could be found). Using standard deviation analysis based on the national sample once again simply ignores the important difference between the average costs of urban areas and the average cost of the country as a whole. Even if one were to accept the validity of standard deviation analysis for setting the benchmark, at the very least section 254 requires that analysis to be applied solely to the statistical cost characteristics of urban areas.

Another problem is that the majority has inexplicably rounded up the results of its own standard deviation analysis. The record shows that a point 2.0 standard deviations above the national mean produces a 132 percent benchmark. The majority has not explained why this evidence supports a benchmark of 135 percent. Raising the benchmark by three points to 135 percent further constricts eligibility for support. The support reduction in states receiving support is $0.50 per line per month, an amount that is not trivial to a high-cost customer.[22]

Finally, note my disagreement with two other statements in the Recommended Decision. I am not aware that the Joint Board has previously found that rates in all parts of the country are reasonably comparable." Also, I do not agree that the major purpose of federal support is to "ensure that rates remain reasonably comparable **as** competition develops.[24] If rates or costs were not reasonably comparable on the day the 1996 Act went into effect, that is a problem under section **254.** I believe the Joint Board should state clearly that the Commission has a responsibility under law to address rate and cost differences, without regard to their vintage. Section 254 creates a duty to **keep** rates and service reasonably comparable regardless of whether local competition has flourished or

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[22] At a benchmark of 132 percent of the national average, every currently supported customer would receive additional suppon of $0.50 per customer per month. $0.50 = ($21 .93 * (135%- 132%) * 76%)

[23] The majority states that the Joint Board has previously found "in prior rulings that current rates are affordable and reasonably comparable," Recommended Decision, ¶ 34. The former is a correct statement, but not the latter. The majority cites the Commission's Seventh Report and Order. That document merely recited an earlier finding that rates are affordable. Nothing in the cited paragraph establishes that rates are or were reasonably comparable.

[24] The majority states that this is "one of the goals" of the Act. Recommended Decision, ¶ 35. The majority's own rationale on this issue is inconsistent. On one hand the majority apparently supports Verizon's argument that rates were reasonably comparable in 1996 and that federal support is needed, if at all. primarily for the intrastate rate variations that were expected to follow the arrival of local competition. ¶ 35. On the other hand. the majority admits that there is no need for federal support when rates are de-averaged in a low-cost state, since with a sufficient intrastate Fund all customers in the state can still have reasonably comparable rates without federal suppon. ¶ 26.

languished and regardless of whether rates have remained static or have been geographically de-averaged in response to competition.

*4. The **Urban** Benchmark*

The majority definitively rejects the use of an "urban benchmark." I find the arguments confusing and unpersuasive. Ultimately, the majority has failed to address the central issue remanded by the court. the relationship between the dollar benchmark. which represents each state's post-support net cost, and the typical cost in urban areas. By insisting upon stating the benchmark as a multiple of national average costs. the majority seeks unsuccessfully *to* avoid the fact that, because urban costs are lower than the national average cost, the benchmark set at 135 percent of the national average is too high.

First. tlic majority suggests that the distinction between rates and costs. combined with the Tenth Circuit decision, somehow prohibit us from increasing cost-based support. The majority states that the "litmus test for noli-rural high-cost support is the reasonable comparability of urban and rural rates," and that "rates do not necessarily equate to *costs.*"" Similarly, the majority states that adopting a cost benchmark that is reasonably comparable to urban cost would be to "substitute a different standard for the statutory rate comparison."[26] I fail to understand this argument, given the majority's own reliance on a different cost benchmark less favorable to rural customers.

The majority recommends continued primary reliance on cost-based support to comply with section 254. **If** the majority believes that local exchange rates are the only valid basis for support, then I do not understand why hundreds of millions of dollars of support should continue to be based on costs nor why the Recommended Decision offers only a vague and indefinite process for calculating rates-based support. It seems that the majority justifies the existing system on the ground that costs equal rates, and at the same time rejects all change on the ground that costs do not equal rates. In my view, so long as we continue *to* place primary reliance on cost-based support, the statute and the court decision require that we establish a dollar benchmark that is reasonably comparable to average urban costs.

Similarly, the majority rejects the conclusion that an "urban cost benchmark would better satisfy the statutory comparison of urban and rural rates."" Underlying this conclusion is the plausible assumption that explicitly relating the dollar benchmark to the national urban average cost would produce a lower dollar benchmark and an increase in support. The majority apparently finds that incremental support would be ineffective at producing comparable rates, but existing support passes the test. I fail to understand why this might be true.

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[25] Recommended Decision, ¶ 41

[26] Recommended Decision, ¶ 39

"Recommended Decision, ¶ 39 (emphasis in original)

Once again, the majority reports that "proponents of the urban benchmark have not explained how additional funding produced by an urban benchmark would produce reasonably comparable rates."[28] The explanation is obvious. Assuming that local rates are based on costs, support based on a comparable multiple of average urban costs will give each state an opportunity to set its own rates at an average level that is reasonably comparable to rates in urban areas of the nation. Other portions of the majority's opinion precisely describe this rclationship.'"

The majority criticizes proponents of an urban benchmark for not providing "a rational justification for setting the benchmark at any particular level."[29] This imposes an unreasonable burden on those proponents, and is in fact a flaw in the majority's own cost-bascd approach. As the majority notes (and the court explained) any determination of a benchmark "will necessarily he somewhat arbitrary."[30] A choice obviously needs to be made from within a reasonable range of benchmarks. But this does not justify putting an unreasonable burden on the proponents of an urban benchmark. In my view, they have carried the entire burden that can fairly be assigned to them. They have shown convincingly that the existing benchmark does not provide sufficient support to make costs in high cost states reasonably comparable to national average urban costs. Moreover, the record **does** contain rational recommendations for a particular level. For example. three regulatory commissions from rural states recommended that the benchmark be set at a level no higher than 125 percent of average urban costs." Even if the majority believes that this particular number is too low, that is no reason to leave in place a benchmark that the record shows is too high.

*5. **Evidence** of Insufficiency*

The preponderance of the credible evidence of record shows that current federal support, based on the 135 percent benchmark, does not provide support sufficient to attain reasonably comparable rates or costs between high-cost rural states and the nation's urban areas. All of this evidence is based on the cost outputs from the Commission's

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[28] Recommended Decision, ¶ 40.

[29] ***See,*** Recommended Decision, ¶ 25 ("Despite implicit or explicit state supporl mechanisms, the low-cost areas of some states cannot balance their high cost areas. Although such states could, through their own efforts. achieve reasonably comparable rates within their own boundaries, those rates would still be high relative to the national average because ofthe states' high average costs. The Commission's primary role is to identify those states that do not have the resources within their borders to support all of their high-cost lines.").

[30] Recommended Decision, ¶ 40

[31] *Qwest* ***Corp. v.*** *FCC,* 258 F.3d 1191, 1202 (10th Cir. 2001); Recommended Decision, ¶ 33.

[32] Comments of Maine Public Service Commission, Montana Public Service Commission, and Vermont Public Service Board at 7. (I do not participate in Montana proceedings concerning matters referred to the Universal Service Joint Board.)

Synthesis Cost Model, but different methods have been used to select an "urban" sample. Despite the different samples, the results are remarkably consistent.

Most notable was a filing from the Rural Utility Service (RUS), a branch of the United States Department of Agriculture. The RUS sampled 17 downtown urban areas to determine average urban cost. It determined that in those urban areas the average "loop cost" was $390 per line" and that the national average (urban and rural) "loop cost" was $672. Therefore a national average 135 percent benchmark amounts to 1.35 times $672 per line. or $007 per line. RUS reported this to be 233 percent of the urban "loop cost" of $390. RUS stated. and I agree. that this amount is fat- outside the range of reasonable comparability.

Another approach would be to use the average cost among those companies that serve solely or primarily urban areas. Unfortunately, however, the value of this method is severely limited by the small sample available. Of 96 nonrural companies. only one even arguably meets the test of serving predominantly an urban area. It is C and P Telephone Company of Washington D.C., a Verizon affiliate.[34] The model currently shows that the average forward-looking cost of providing service in the District is $1 6.03. The current benchmark of $29.60 is 185 pel-cent of this estimate of the national urban cost. Once again, this method shows that the current benchmark is far outside the range of reasonable comparability.

Yet another model-based approach is to use the density zone feature of the cost model." The FCC currently recognizes nine such zones. The three densest zones have a density of 2,550 lines **per** square mile **or** more. Together, these wire centers comprise 28 percent of all lines and in my view offer a reasonable set estimate of "urban" areas." The weighted average cost in these three density zones is $1 6.34. The current benchmark of $29.60 is therefore 181 percent of national urban cost. Once again, this method shows the benchmark is far outside the range of what might be considered reasonably comparable.

Still another way to measure "urban" cost is to adopt the definitions of "urban" used by the United States Bureau of the Census, This analysis also confirms that the Commission is not today providing sufficient support. The Census Bureau defined urban

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[33] In most discussions of universal service, the standard unit of measure it total cost per line per month. The RUS used a different yardstick, but one still based upon the Commission's own cost model.

[34] Even C&P of D.C. may not be entirely "urban" since some census block groups in Northwest Washington are primarily suburban.

[35] The Synthesis Model was originally designed with the capability of producing costs by density zone or by wire center, as the modeler may select.

[36] At the lower edge of 2,550 lines per square mile, this amounts to approximately one-quarter acre per line. Since many residential and business customers have more than one line per occupied structure, this means that some areas in this zone have an average lot size larger than one-quarter acre. A generous definition of "urban" follows from using the higher costs associated with areas with large lot sizes.

areas for the 2000 census" as areas that are contained in either an "urbanized area"" or an "urban cluster."[39] Staff from the Joint Board has utilized public domain data to identify those wire centers that are predominantly urban.[40] Ohio data were used because it happened that wire center boundaries for that state were available in the public domain."[41] The resulting estimate of urban average cost is $18.02. The current benchmark of $29.60 is therefore 164 percent of this estimate of national urban cost. Once again, this method shows that the benchmark is outside the range of reasonable comparability.

In summary. using a variety of methods, the record reveals that the existing system supports net cost differences where rural areas have net costs that arc somewhere between 164 percent of urban average cost and possibly as much as 233 pcrcent of urban average cost. None of this evidence is consistent with a view or finding that the existing system is providing sufficient support to make net costs in high-cost states reasonably comparable to urban areas of the nation. For these reasons, I conclude that the existing system. based on a benchmark of 135 percent, does not meet the requirements of the statute.

6. Other Considerations

Some may be reluctant to use an urban average or decrease the benchmark because they have limited confidence that some of the states receiving added support

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[37] The Census Bureau noted that some agencies are required to that some Federal and state agencies are required by law to use Census Bureau-defined urban and rural classifications for allocating program funds, setting program standards, and implementing aspects of their programs. Federal Register: March 15, 2002, Volume 67, Number 51, Notices, pages 11663-11670.

[38] For Census 2000, an urbanized area consists of contiguous, densely settled census block groups (BGs) and census blocks that meet minimum population density requirements, along with adjacent densely settled census blocks that together encompass a population of at least 50,000 people. *id.* Ohio has 19 urbanized areas. Internet cite: http://www.census.gov/geo/www/ua/ua_state_corr.txt.

[39] For Census 2000, an urban cluster consists of contiguous, densely settled census block groups and census blocks that meet minimum population density requirements, along with adjacent densely settled census blocks that together encompass a population of at least 2,500 people, but fewer than 50,000 people. *Id.* Ohio has 143 urban clusters. Internet cite: http://www.census.gov/geo/www/ua/uc_state_corr.txt.

[40] Predominantly urban was defined here as enclosing an area that is more than 50% urbanized area or urban cluster.

[41] Because Ohio is a sizeable state with both rural and large city wire centers, it provides a good sample for urban costs nationally. Data for the entire country were available for $5,000, but the Joint Board declined to make this expenditure. For each of 903 wire centers in Ohio, staff determined the percentage of the wire center's area that is characterized as "urbanized area" by the Census. 52 wire centers were then selected which serve areas that are at least 50 percent "urbanized areas." Of these, 39 were served by nonrural carriers. and therefore average cost data were available. The average cost of these 39 wire centers, weighted for line size, was $17.63.

actually need that support. In other words, some may doubt that the states with high forward-looking cost actually need more support. Fortunately, several reasonable solutions are available to the Joint Board that should assuage that concern and allow the Joint Board to recommend a support mechanism that provides sufficient support to all.

The first question is the accuracy of the model itself. One might support the underlying methodology of using forward-looking costs but might doubt the reliability of costs calculated under the existing cost model. In the nearly three years since issuance of the last significant order defining the model." several potential problems with the model have been identified,[43] but the Joint Board has declined to investigate these matters. Opportunities to make significant improvements to the model have also been missed.[44] So long as the Commission continues to distribute support based on a forward-looking cost model, it should maintain a staff with expertise on the internal workings of the model, and it should devote substantial continuing resources toward improvement of that model. Moreover, the Joint Board should bc actively involved in these activities to test, evaluate and improve the model. I am vcry encouraged that Joint Board chair Abernathy has committed to do this in the future.

The broader question is the propriety of distributing support using costs that are different from tlic costs that states use to set rates. This concern is reasonable, because support and rates are calculated in most states using quite different costing rules. The Joint Board has previously recommended, and the Commission has adopted, a system of support for nonrural carriers that is based on forward-looking costs. **As** a result the existing support system provides support to some areas with apparently **low** rates, and provides surprisingly little support to some areas witb apparently high rates.

Even if one holds this objection, I do not think it should stand in the **way** of providing more support here. One option would be to lower the benchmark but to deny support increases to carriers unless they also have above average embedded costs. Since all incumbent carriers still have an interstate revenue requirement, data on this question is

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[42] The last order establishing significant parameters of the cost model was the Tenth order, issued in November of 1999.

[43] The Rural Task Force identified a number of areas in which the model appeared to produce unreasonable results for rural companies. In addition, there are potential problems with use of the model even for nonrural companies. For example, the model deploys loop plant without regard to natural and manmade barriers such as mountains, lakes and highways. **Also,** the model inputs now include many more special access lines than were originally anticipated, largely due to the unexpected sale of thousands of DS-I and DS-3 special access circuits. Some of these circuits are sold to competitors. others **to** schools and libraries using subsidies from federal universal service funds. We have nor investigated whether those circuits are currently being assigned to the proper wire centers nor whether the model is properly adjusting switch, feeder **and** distribution plant to accommodate these new circuits.

[44] More than one year ago FCC staff had developed a redesign of the model so that it constructed plant solely along rights of way. That modification significantly changed costs in some areas. but had the potential to improve the reliability of the model in areas with significant topographic limitations. However, all work stopped on those modifications when a **key** FCC staff member left the Commission.

already available through NECA. Thus embedded costs could be used as a screen to prevent forward-looking support from increasing increases in places that are likely to have low rates.

More fundamentally, there may be general dissatisfaction with basing support on forward-looking costs because they have so little relation to customer rates. If so, this would justify a general review of the existing support mechanism. If we are unwilling or unable to conduct such a fundamental review, however, that *is* not a reason for us today to deny sufficient support to high-cost nonrural carriers.

The majority has rcconnmcnded no increase to cost-based funding for nonrural carriers. That analysis will comfort thosc who wish to ensure that the overall Universal Service fund does not grow as a result of this proceeding. To place this in context, however, it is important to understand the small effect this program has on the overall fund size. High cost fund support for nonrural carriers comprises only 4.3 pcrccnt of the total universal service support mechanisms."[45] Accordingly, even if forward-looking support to nonrural carriers were doubled (or if it were eliminated entirely) there would be only a small effect on the overall size of the fund.

B. Rates-Based Support

The court directed the Commission to explain how its cost-based support is designed to produce reasonably comparable rates. Instead, the Joint Board recommends adoption of an entirely new rates-based support mechanism characterized as a "supplemental rate comparability review"." The rationale apparently is that even if the cost-based system does not provide sufficient support, then the availability of a supplemental proceeding can ensure compliance with the statute. Thus the Joint Board recommends that compliance with the statute no Longer be measured solely by reference to a known objective formula against which results can be independently verified. Instead, it recommends today a new subjective system with rules that will be established on an ad hoc basis through agency case law and practice.[46] For the reasons explained below. I conclude that creation of this new supplemental proceeding at this time does not comply with the Commission's duties under section 254 and with the terms of the court's remand directive.

1. Sufficiency of Cost-Bused Support

Section 254 became law six and one-half years ago. It contained language suggesting (but alas not requiring) that rates should promptly be made affordable, and rates and service reasonably comparable. For all those years the customers of high-cost nonrural carriers have lacked assurances that their rates and service are reasonably comparable to urban areas. The court has clearly directed the Commission to explain the

[45] FCC, ***Universal Service Monitoring Report***, *CC* ***Docker No. 98-202, Summer, 2002.*** Table 1.11

[46] Recommended Decision, ¶ **38.**

relation between its cost-based support program and the statutes. Neither the Joint Board nor the Commission has ever found that current rates in all areas of the country are reasonably comparable to urban areas. Once again, the Joint Board fails to do so today. The Commission cannot avoid this statutory responsibility forever.

Today the majority recommends essentially that the Commission go back and start again, basing sufficiency not on its well-defined (although deeply flawed) forward-looking cost-based system, but on a new and as yet undefined rates-based system. Having received a referral on this issue. I believe the Joint Board now has the obligation either to explain how cost-based support is sufficient or to change that support.

The recommendation for a supplemental rates-based support system does not discharge that duty.[47] It is not an adequate response to tell customers, six and one-half years after the Act became law, after adopting a new cost-based support system, and after losing a remand from the Court of Appeals, that if customers or their service providers want sufficient support they may file a petition. I doubt such a plan would have been reasonable even in 1997 when the Commission first selected a broad direction for its support program." To make this suggestion now, however, while making no change at all in the existing cost-based system, is an affront to those customers. One foreseeable effect will more years of'delay before Section 254 is meaningfully implemented fur customers of large carriers.

I understand the majority to conclude that even if cost-based support is insufficient, section 254 can he satisfied if there exists a supplemental rates-based system that uses case-by-case determinations, and further that this new system need not publish in advance the rationales, algorithms or calculations that will he used to provide support. I am greatly concerned that this decision may he applied in the future to small rural carriers. While these carriers serve a minority of rural customers nationwide, in most states they serve areas that are predominantly rural. In many cases they have few or no low-cost customers upon whom to rely for low averaged rates. Accordingly, insufficient cost-based support is a problem for relatively few of the large nonrural carriers, hut it can he a matter of great importance for the customers of small rural companies. Because I believe today's Recommended Decision supports continuation of insufficient support, I believe it is a particularly worrisome development for rural carriers and their rural customers.

2. *Burdening the Stares*

Under the majority's opinion, states must apply for supplemental support. This unlawfully shifts the federal responsibility to the states, and it does not ensure that

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47 This principle may be ofsignificance in the upcoming discussion o f support for rural carriers. Rural carriers may be very interested in the establishment of a precedent that cost-based suppon need not, by itself, be sufficient to allow reasonably comparable rates.

48 I also note thai the Commission did not provide suppon for nonrural carriers until 2000 because it felt it necessary to spend several years developing its new forward-looking cost model.

ratepayers in high cost states will receive sufficient support to achieve comparable urban and rural rates.

Sufficient support will be provided only if the state chooses to **seek** it and if the state succeeds in making the required showings. **A** state might avoid such an undertaking for a variety of reasons. The proceedings will require considerable expertise and could be contentious. Many adjustments to rates are possible, but the parties are not given any guidance as to what adjustments will be accepted. Litigation costs, particularly for experts. could be sizeable. While some high cost states may have the resources and expertise to make the required showings. others are unlikely to accept this challenge.

The majority may have misunderstood the court's decision regarding inducements. I read the court's decision to require the FCC to create inducements for the states to deal with any rate differences that ma); exist within their own borders. I do not believe that the court intended to permit the Commission to deny sufficient federal support to customers in a state where, for whatever reason, the state commission has elected not to apply for that support.

3. Appropriate State Roles

The majority's analysis repeatedly neglects the important difference between rate variation within a state and rate variation among the states. It is elementary that a dollar raised by a state universal service program is not only a dollar available for rate support in that state, but it is also a dollar that is added to local rates in that same state. Therefore, while state universal service funds can be highly effective at reallocating internal burdens within the state's boundaries, they are powerless to reduce the state's average rates or to change the state's ranking among other states. Intrastate equity is within the sphere of what a state can and should accomplish. State-to-state equity is beyond any state's means and has been recognized as the proper responsibility only of the Commission.

Ominously, the blurring of this distinction occurs in the section on inducements. The Recommended Decision discusses the new supplemental proceeding in the section on inducements, thereby suggesting that there should be some sort of connection between a state's performance of its own duties under section 254 and the availability of sufficient federal support. Indeed, the Recommended Decision says that an applicant should show it has "taken all actions reasonably possible and used all available state and federal resources to make basic service rates reasonably comparable, but that rates nevertheless fall above the benchmark."[49] This might be a relatively harmless (although still facially improper) requirement if all it means is that the state must, one way or another, keep rates within its borders reasonably uniform. States have a variety of tools to accomplish this.[50] On the other hand, this language may be a warning that only states with substantial

[49] Recommended Decision, ¶ 50.

[50] Most states rely on rate averaging for their nonrural carriers. Increasingly, however, states are replacing these systems with explicit universal service programs.

intrastate universal service fund mechanisms need apply. That would be a clear violation of section 254. **A** rural state having uniformly high rates and costs might need substantial federal support yet have no need for a state universal service fund because its rates are comparable *within* the state. Section 254 does not require states to establish universal service funds." The Commission has no authority to make the existence of a state universal service fund a condition precedent to sufficient federal support.

The "safe harbor" language also seems to be similarly confused about the extent of state duties. Apparently before a state may seek supplemental support it must first admit that it has anchored outside the newly announced "safe harbor." Once again this overlooks the difference between intrastate and state-to-state rate variations. It may even prove to he a new kind of "Catch-22" for applicants. To apply, the state must admit that its ratcs have fallen outside the "safe harbor." This suggests that the Commission's first inquiry in a supplemental support proceeding may be an inquisition into whether the state's own universal service efforts have been adequate.[52] It remains to be seen how the Commission will respond to facts showing that the state lias no internal high cost program because its rates are uniformly high.

I believe today's Recommended Decision should confirm earlier statements from this Joint Board and by the Commission that states are powerless to remedy state-to-state variations in rates and that this *is* the chief object of federal high cost policy. We should remove any suggestion that we believe that all states outside the "safe harbor" necessarily have some responsibility for that fact. **Also,** if there is going to be a supplemental proceeding, we should clarify that the proceeding has nothing to do with state inducements.

4. The New Proceeding

The Recommended Decision provides few details about the new supplemental proceeding. The majority apparently envisions developing the details through administrative case law and practice." States must present a "rate analysis," but they are also to be given "great flexibility" in their presentations.[54] Of primary importance here is the complexity of obtaining valid comparative rate measurements. **As** many as 30 different adjustments to raw rate levels may be necessary to make meaningful rate comparisons. Foreseeable adjustments may fall into five major groups:

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[51] Section 254 provides that "**A** State *may* adopt regulations not inconsistent with the Commission's rules to preserve and advance universal service." 47 **U.S.C.** § 254(f) (emphasis added).

[52] Ironically. the requirement that rates fall outside the "safe harbor" may actually require states to deaverage rates in order to qualify for Federal USF. This would likely have the effect ofreducing rate comparability in high cost areas. contrary **to** the statute.

[53] This can be contrasted with the "safety valve" mechanism adopted last year for rural carriers. That mechanism is clearly defined. Carriers are able to calculate exactly the amount o f support available under that mechanism and to verify that the amount provided agrees with the Commission's rule.

[54] Recommended Decision, ¶ 56

- Rate for Basic Local Service. Some customers face unavoidable extra charges for local exchange service. Other customers have simpler and more inclusive rate designs. Also, some customers have the option of choosing from a variety of local calling options. A particular customer may have a choice, for example, to select a more expensive plan that includes more local calls, more calling time or a wider calling area.

- Quality of Service. Differences in service quality may be the result of different investment and maintenance decisions.

- Calling Area Size. Some state calling arca policies change the value ofservice to the customer in ways that do not appeal- in the nominal local exchange ratc. The size ofthe local calling area is one important variable. Some customers have a large calling area that can extend for fifty miles or more. Customers in other areas, however, have relatively small calling arcas, and they must pay toll rates when they make calls to local schools and nearby businesses, possibly even to Internet providers. For the latter group. toll hills are generally higher and local rates are generally lower. For this reason, two customers may have the same local exchange rates yet, because they have local calling areas of different sizes. comparisons of their local exchange services may not be valid.

- Intrastate Toll and Access Rates. States differ in the degree to which they allocate joint and common costs to toll services. In some areas significant joint and common network costs are included in toll and access charges, and local exchange rates are low. In other states with different policies, local exchange rates would be higher, but toll rates would be lower. For this reason, two otherwise identical customers may have different local exchange rates based solely on state policy regarding the division of common costs between local and toll services.

- State Regulatory Policies. Local exchange rates can in some instances reflect state regulatory policies that might be inappropriate to include in support calculations. A carrier may, for example, be earning an exceptionally high rate of return on its net plant investment. Another carrier may be using aggressive depreciation techniques for new equipment purchases. There are differences that may also be important related to capital structure, cost of debt, and interest synchronization.

Given the stakes, states may, and undoubtedly will, present dozens of adjustments in their "rate analyses." No two applicants will analyze their rates in the same way. One state may make large corrections for its relatively small calling areas. Another may emphasize one or another aspect of a rate design that permits customer to select from among several calling plans offering different kinds of prepaid services.[55] A third may

[55] For example, the **GAO** study noted that customers in Michigan had an alternative between one "message rate" calling plan costing $12.01 and another "unlimited basic service" plan costing $43.95. The **GAO** (continued....)

argue that its high intrastate toll and access rates should be considered.

The Commission already has experience with each state defining its own costs, if not rates; and it justifiably abandoned the experiment. In 1997 the Commission announced that states were encouraged to perform and file their own state-specific forward-looking cost studies, and that those studies might later be used to determine a state's support." Later, the Commission withdrew this offer, finding that only a uniform national-wide cost model could make appropriate support calculations. Individual state models, the Commission held:

> could rely on differing forward-looking cost methodologies, including differing assumptions or input data elements that would prevent meaningful comparisons ol'the resulting forward-looking cost estimates, and thus would provide a less accurate and consistent picture by which we could evaluate the cost levels that must be supported . . . .[57]

The Joint Board here proposes a state-by-state approach with rates that is quite similar to the long-abandoned state-by-state cost studies. With each state free to suggest its own procedures for adjusting rates, it seems that there is a sizeable chance of uneven and even discriminatory results.

Moreover, a state petitioner may not even have access to the data needed to prove its case. Suppose a state decides that it should adjust its local exchange rates to account for unusually small calling areas. Can it compare its own adjusted data with unadjusted rate data from other states? If not, how can it get adjusted data for other states?

Today's Recommended Decision offers no guidance about how these issues will be resolved. Applicants are not told whether they should adjust rates for local calling area size, or how they should report rates when customers have choices among calling plans with different calling scopes **or** different numbers of included calls.[58] Who will win supplemental support? How will such support be calculated? The majority provides no answer. The Commission will have a very difficult time sorting through these competing claims and establishing the credibility of its new system as impartial and objective.

(Continued from previous page)
study used the higher figure. If Michigan were to apply for support, it would presumably use that same number.

[56] First Order, ¶ 206; Second Order. ¶ 31

[57] Seventh Order, ¶ 52.

[58] Commendably, the Recommended Decision does suggest that there should be a time limit for such a proceeding. I agree that it is important that requests for supplemental suppon must be processed and decided expeditiously. Without such a limit, a proceeding could be initiated by a state or carrier, be noticed for comment, and then remain undecided for years. For example, the Vermont Public Service Board filed a petition for waiver of existing universal service rules in September of 1993. The Commission never acted on that petition *In re Waiver of Section 36 631 of the Commission's Rules Governing the Universal Service Fund*, Docket No. AAD 93-103, public notice issued Oct. 15, 1993, *8* FCC Rcd. 7588.

Moreover, it will probably take at least another year before we find out how this new proceeding really will work.

5. *Risks **and** Incentives*

A new and embryonic proceeding presents new risks and opportunities to the Commission and to the states. One risk is preferential or discriminatory treatment. Future Commissions have virtually unlimited discretion to define "rates" as they choose and then to award support or lo withhold support, there is a substantial risk that they may consider factors not stated in a written decision. 1 o avoid this kind of risk. government support programs of all sorts have been operated on a formula basis and have avoided case-based ad hoc decisions.'" Apparently the majority does not consider prcfcrential or discriminatory treatment a substantial risk.

I mrntioned above that the parties in a supplemental support proceeding may propose adjustments related lo state regulatory policies such as authorized rates of return, depreciation, capital structure or interest synchronization. This will involve the Commission in reviewing the reasonableness of state rate decisions. If the rates actually being collected reflect a high "authorized ratc of return" or high actual earnings, for example, the Commission may be asked to impute a lower rate of return. This would require it to substitute its judgment for that of the state commission. In the extreme. the Commission could find the proceeding grows essentially into an ersatz intrastate rate case. It may even be necessary to audit some company records. This would not only prove harmful to comity with the states, but it could be well beyond the actual staffing capacity of the Commission.

A new rates-based support system could create perverse incentives for carriers. When it initially adopted a forward-looking cost model for support, the Commission expressed concern that an embedded-cost system would create undesirable incentives for incumbent carriers. If support were based on embedded cost, the Commission thought that incumbent carriers would make inefficient investments and have a disincentive to efficient operations and new competitors would be deterred from entry.[60] But now the Joint Board proposes to base support upon the local rates that are, in most places, based on embedded costs. Once banished, the problem has now returned. The Commission may have to choose between initiating company audits or providing support for costs that are not essential to the services supported by universal service. Short of audits, nonrural companies may have practically unrestricted ability to generate support based on any infrastructure investments they desire and that are recognized by state commissions.

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59 Formula-based federal suppon is provided to the states across a **wide** range of public policy, including transportation support, farm supports, and health care support.

60 Federal-State Joint Board on Universal Service, CC Docket No. 96-45, Report and Order, **12** FCC Rcd 8776 (1997) (Universal Service Order), as corrected by Federal-State Joint Board on Universal Service, Errata. CC Docket No. 96-45. FCC 97-157 (rel. June 4. 1997) (hereinafter "First Report and Order") ¶ 228

A new rates-based support system also creates a new moral hazard by establishing perverse incentives for state commissions. Rates-based support will create an incentive for state commissions to maximize their support, even if it requires changes to local rate designs. Unless the method of measuring rates is carefully controlled, states may find themselves performing major redesigns of local rates. If for example, no adjustments are allowed for calling area size. states will have an incentive to increase calling arcas. "One-state-one-rate" may become the motto of high-cost states around the country. Also, if no allowance is made for toll and access charges. slates will have an incentive to reduce those charges and redesign their rates *to* increase local exchange charges.

Finally the new system also presents a potentially issue to those who are concerned about the total size of the Universal Service Fund. Of course the entire support program lor nonrural carriers amounts to less than five percent of the total universal service fund. Still, given the broad uncertainties in how local rates will be measured and how support will be calculated, the ultimate effect may be a significant increase in the high cost support for nonrural carriers.

C. Transport Issue

Finally, the transport issue has not been addressed here. In its supported services recommendation the majority promised to take **up** and address here the issue of high transport costs. Without support, those companies with high transport cost will not receive sufficient support to allow their rates to be comparable with urban areas.

We recently issued a Recommended Decision on supported services. One of the questions discussed there was federal support for transport costs. I said at the time that I wanted to examine this issue as soon as possible because very high unsupported transport costs are the primary barrier to establishing telephone service in certain remote areas. The majority ultimately stated that we would analyze the question of whether support should be modified for transport costs, and that the analysis would occur here, in the context of the Tenth Circuit remand."[61] We have not performed that analysis, and I regret the omission. I continue to believe that high transport costs must be examined immediately to ensure compliance with section 254 of the Act."[62]

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[61] In that Recommendation the majority said:

The Joint Board recognizes that issues related to the cost of transport facilities are important and may be of particular concern in rural areas of rural and non-rural companies. Transport may be a necessary element of a carriers' provision of services eligible for federal universal service support In some remote communities, customers must use the interexchange network to access essential community services such as law enforcement, health care, schools and libraries. *The extent lo which these costs should be supported is best addressed in our recommendation on ihe decision remanded from the Tenih Circuit where we will analyze reasonable comparability and sufficiency of support. In that proceeding, we will consider the level of support necessary* lo ensure that all citizens of the United States have access to reasonably comparable communications services. Recommended Decision FCC 02J-1, ¶ 57 (emphasis added).

[62] See, Separate Statement of Bob Rowe, Pan V I